ATTACHMENT

Suggested Topics for Item 1 of the Agenda for Monday, August 22

1. Conceptual and presentational issues arise from recent efforts in Congress--in connection with the budget process and the monetary policy oversight hearings--and elsewhere to have the Federal Reserve specifically declare its "objectives" for nominal GNP, real GNP, and prices. Congressman Fauntroy has held hearings on a bill to that effect (with Chairman Volcker testifying), and the process of deliberation and discussion can be expected to continue, with further responses from the System needed.

a. Conceptual issues

(1) Over the longer-run, under existing and reasonably foreseeable conditions and given the policy tools at its disposal, how should the Federal Reserve construe its responsibilities for the nation's economic objectives of reasonable price stability and economic growth? If the Federal Reserve has a special responsibility for the price level over time, what is an appropriate quantitative objective? To what degree should that objective be balanced against economic growth (is there a trade-off)? How would the longer-run fiscal outlook affect the stance and objectives of monetary policy over time?

(2) Over the shorter-run, and taking account of experience of the past decade, how should policy adapt to possible trade-offs between, for example, economic growth and price stability, in light of exogenous shocks (such as the oil price increases), the stage

of the business cycle, or international concerns? What, if any, trade-off do you see between fiscal and monetary policies in the near-term?

b. Presentational issues

(1) Should ultimate economic goals be given clearer expression in conveying FOMC policy intentions to the public through, say, a specific numerical statement of objectives (with respect to prices or nominal or real GNP) over an extended period--e.g. 5 years?

(2) Or should expressions about ultimate economic goals continue to be limited to general qualitative statements, with numerical specifications for "projections" only a year or two ahead.

2. Possible procedural improvements in the flow of economic information might be considered as part of a continuing effort to make the meetings as productive as possible and also in the context of sharpening, if needed, consideration of longer-run issues as they interact with and shape current policy.

a. Should there be a special meeting devoted exclusively to long-run structural considerations--e.g. productivity trends, fiscal policy outlook, changes in financial structure--and how they affect possibilities of real growth, price stability, and monetary and credit targeting over an extended time horizon.

b. How often should numerical economic projections be updated--every meeting, less frequently (with more qualitative assessments substituted)--and what should be the forecast horizon?

c. Should presentations to the FOMC include, at least on occasion, forecasts or qualitative assessments from alternative sources?

Notes for F.O.M.C. Meeting
August 23, 1983

Sam. Y. Cross

Since your last meeting the dollar has experienced a very sharp rise and fall, leaving it now only slightly higher on balance against most foreign currencies than it was five weeks ago. Against the German mark, whose exchange rates were the most volatile, the dollar rose almost 6 percent to a 9 1/2-year high of DM2.7440 before falling sharply within the last two weeks to end with a net gain of just 1 percent.

The dollar's rise accelerated in the second half of July as fresh evidence of the strength of the U.S. economic recovery--seen in marked contrast with relatively weak performances abroad--heightened anticipation that growing private credit demands would soon clash with the financing needs of the U.S. government and force dollar interest rates higher. As U.S. domestic markets prepared to absorb the Treasury's large quarterly refinancing, uncertainties about the extent of expected interest-rate rises were transmitted to the increasingly nervous foreign exchange markets. Publicized reports about the payments difficulties of Brazil and other sovereign borrowers also contributed to anxieties over the implications of higher interest rates and prompted some buying of dollars as a safe asset.

Against this background, the dollar ratcheted upward in unsettled trading, meeting less resistance as it passed important benchmarks that it had not been able to sustain before. When the dollar broke through the psychologically important level of DM2.60, many corporate treasurers apparently moved to cover dollar needs that they had postponed and this added to the dollar's upward momentum. Major market makers became less willing to perform their normal positioning function causing the market to lose resiliency and to become subject to sharp rate movements. In these circumstances, the U.S. authorities entered the market in coordination with foreign central banks to restore orderly trading conditions. In these concerted operations foreign central banks sold \$2.4 billion, while we sold a total of \$254.1 million of which \$182.6 million was against German marks and \$71.5 million against Japanese yen. Our operations were conducted, on four trading days, at times when the dollar began rising sharply during U.S. trading hours, and were shared equally between the Treasury and the Federal Reserve.

The intervention started at a time when conditions were deteriorating and markets were becoming progressively more disorderly. It succeeded in cushioning the dollar's rise, and trading became more settled in the early days of August. But the dollar moved higher again after statements by German officials were interpreted to mean that the German authorities would not raise interest rates to protect their currency, an action which many had come to expect. After consultation with Bundesbank officials the U.S. authorities decided not to intervene.

After hitting its highs on August 11, the dollar reversed course at the same time that prices in the domestic bond market began to turn up again, in response to a reversal of market sentiment and expectations about a further rise in U.S. interest rates. With many exchange market professionals once again positioned the wrong way, the dollar's movement quickly acquired momentum, and at its lowest point last week, the dollar had fallen in terms of the German mark by about 5 percent in as many trading days.

These experiences have left several impressions on participants in the foreign exchange markets. One is that central bank intervention in the present environment is not likely to stop a strong rise in the dollar or, for that matter, its fall. In part, this is a healthy recognition by traders that the central banks are, as they have often said, prepared to intervene mainly to counter disorder in the markets and will not often try to resist fundamental trends in exchange rates. Another impression is that monetary authorities in the major European countries are willing to accept some depreciation of their currencies vis-a-vis the dollar, rather than jeopardize what they view as still tentative recoveries in their own economies by following U.S. interest rates upward. The absence of immediate fear of inflationary consequences, in view of weak domestic demand in these countries and relatively restrained commodity price increases, has contributed to this attitude, which has become much clearer to people in the market following recent official statements and actions in Germany, Switzerland and the United Kingdom.

Following the volatile movements of exchange rates in the past several weeks, market participants are still trying to assess their implications and the outlook for the future. The recent fall of the dollar suggests that there may not be much support for it at the higher levels. But the fundamental causes of the recent moves remain little changed, and views about the future course of interest rates are still uncertain. Thus the conditions underlying recent exchange rate volatility have not disappeared and the possibility cannot be excluded that we will have more episodes of similar character. Indeed it is not much of an exaggeration to say that, aside from significant changes in market expectations about interest rate prospects, almost nothing really happened to cause the dollar to rise and fall so sharply.

In other operations, the Bank of Mexico repaid on August 15 another $310 million on the combined $1.85 billion B.I.S.-U.S. credit facility, using the proceeds of an IMF drawing. Half of this amount was paid to the U.S. authorities, $54.25 million on the special Federal Reserve swap line and $100.75 million to the U.S. Treasury. The remaining $1.2 billion of the entire facility is being repaid on schedule, August 23, in part using monies which the Mexican central bank had placed on deposit with the B.I.S. earlier. This final payment to the U.S. authorities comprises $395.3 million to the U.S. Treasury and $214.8 million to the Federal Reserve. The B.I.S. facility is now fully paid off and closed out, and of course the regular Federal Reserve swap of $700 million was paid off earlier.

On July 26 the U.S. Treasury paid off the last of its foreign-currency denominated securities, or Carter bonds, amounting to $607.3 million equivalent of German marks. The Treasury used marks warehoused with the Federal Reserve to cover this repayment, thereby eliminating all balances warehoused for the Treasury.

F.O.M.C. Recommendations

There are no outstanding swap commitments that will fall due in the period September 3, 1983 through October 14, 1983, which includes the first 10 days following the next scheduled meeting on October 4, 1983.

PETER D. STERNLIGHT
NOTES FOR FOMC MEETING
AUGUST 22-23, 1983

Domestic Desk operations since the July meeting of the Committee have aimed to achieve the slight, further increase in restraint on bank reserve positions agreed on at that meeting. Market sentiment tended to reinforce the Desk's stance, reacting to news of further strength in the economy, heavy Treasury cash needs, and continuing above-path growth in M1. In this setting, interest rates rose appreciably through much of the period, reaching a peak around August 8 to 10 when market confidence was at a particularly low ebb. Since then, information suggesting a more moderate pace of economic expansion, abatement of money supply growth and a pause in the Fed's move toward restraint encouraged a notable brightening in market atmosphere, and most of the earlier rate increase was reversed.

The M2 and M3 measures turned out weaker than expected in July, at annual rates of about 6 1/4 and 5 percent--each somewhat under the 8 1/2 and 8 percent paths for June to September sought by the Committee. The weakness was most pronounced in the non-M1 components of these broader measures, while M1 growth of about 9 percent somewhat exceeded the indicated June-September pace of 7 percent. Early August data suggest a slowdown in M1 from the July rate, probably accompanied by some pick-up in the broader money measures.

Typically, the Desk aimed for weekly nonborrowed reserve levels consistent with adjustment and seasonal borrowing of $700 million and excess reserves of $350 million. In practice, borrowing levels somewhat exceeded the objective, averaging a little over $900 million, while average excess reserves slightly exceeded $400 million. In addition to the slightly higher-than-expected demand for excess reserves, the relatively high borrowing levels reflected a tendency for banks to use the window fairly heavily in the early part of most statement weeks. Moreover, even though the Desk moved to meet projected reserve needs fairly fully and promptly, there was a tendency for reserve factors to fall short of estimates more often than not. On a couple of end-of-week occasions, the substantial borrowing early in the week was a factor leading the Desk to be content with nonborrowed reserves somewhat short of path.

Against this background typical Federal funds trading rates worked up from around 9 1/8-1/4 percent just before the last meeting to about 9 5/8 percent or a little over in the last two full statement weeks. In the current week, the rate has edged off to about 9 1/2 percent.

Attainment of reserve objectives generally called for the Desk to supply reserves over the period. The System bought about $2.1 billion of bills outright from foreign accounts, particularly in the latter part of the period. In part, the sizable availability of bills from those accounts reflected the currency support operations undertaken by several foreign central banks. Reserves were also supplied temporarily through System repurchase agreements on a couple of days and a pass-through of foreign account repurchase orders on numerous occasions.

Market interest rates followed a see-saw course over the period, with a modest net rise on balance. Sentiment was cautious to gloomy much of the time, and indeed seemed to reach particular depths shortly after the Treasury's large refunding auctions in early August. At that point, rates on Treasury coupon issues had moved up sharply in the preceding couple of weeks, but investors had little appetite for the securities that the dealers had just bought in substantial size. Factors weighing on sentiment included the strong business news, the information that M1 was pushing above its newly defined and "liberalized" monitoring range, a sense that the Desk was at least tolerating and perhaps encouraging continued firming, and not least the sheer size of the Treasury issues themselves. Pronouncements of well-known market commentators predicting higher rates ahead reinforced investor determination to stay on the sidelines.

The mood changed in the second week of August from abject despair to relief and even a bit of cautious elation. Rather quickly, the high yields that had developed began to look quite attractive. News of the flattening in retail sales in June and July was a significant psychological plus, soon reinforced by smaller-than-expected increases in money supply and a sense that the System was content not to press for firmer conditions for the time being. From August 10 to 20, the market recovered most of the price declines of the preceding few weeks. Long-term Treasury bonds rose a net of about 20 basis points over the period, but had been up as much as 75 basis points around August 8-10. The Treasury's new refunding issues, which had all been trading below issue price a few days after the record sized auctions on August 2-4, commanded premiums of 1 to 4 points by the end of the period. The Treasury raised most of its net new cash during the period in the coupon market--$13 billion out of $18 1/2 billion, the balance being raised in bills.

On balance, bill rates rose quite modestly over the period, with declines in the last couple of weeks nearly offsetting the increases through early August. Yesterday, 3- and 6-month bills were auctioned at about 9.18 and 9.29 percent compared with 9.07 and 9.26 percent just before the last meeting. Other short-term rates showed only small net increases over the period, although major banks raised their prime rate 1/2 percent to 11 percent on August 8, at a time when market rates were temporarily at a peak. The retreat of rates on CDs and other short-term bank funding costs since then has lessened the pressure for a further rise in the prime rate which had looked like a good bet earlier this month.

Corporate bond yields showed similar increases to intermediate- and long-term Treasury issues, even though corporate issuance was on the light side. Tax-exempts also had comparable increases in moderate activity, with housing related issues especially in evidence. The tax-exempt market has continued to be selective in its response to the WPPSS default. The WPPSS issues themselves have been severely impacted and trade erratically in a speculative market. Other Washington State issuers have had to pay somewhat more for their borrowings just because of their location, but the tax-exempt market in general seems little affected.

Returning for a moment to the current state of market confidence and expectations on the rate outlook, there now seems to be a rough balance and a trading range that could persist for a while. Dealers and investors are cautious, but rates climbed high enough so that some investors have found them attractive. Market seers seem to be pretty well divided. There are those who still anticipate further significant rate advances as private credit demands in an expanding economy bump against a voracious Treasury appetite. But others are convinced that rates are likely to head down--pointing in some cases to factors like low inflation and probable moderation of business gains, or in other instances to the recently slower growth in various reserve measures. This is what makes markets.

Finally, I'd like to report that the Desk recently began trading with two dealers that had been on our primary dealer reporting list for a considerable time--Crocker National Bank and Refco Partners. We are also on the verge of adding another dealer to the primary dealer reporting list--Manufacturers Hanover Trust. That will bring the number of reporting dealers back to thirty-six.

James L. Kichline
August 23, 1983

FOMC BRIEFING

The information now available on the economy points clearly to a substantial further rise of real GNP this quarter. Employment and output rose strongly in July following the sizable monthly gains in the preceding few months, and final sales generally have been well maintained. The staff's forecast entails an increase of real GNP of about 8 percent annual rate this quarter, followed by 5 percent in the fourth quarter and around 4 percent in the quarters of 1984. This is not much different in pattern from the staff projection presented at the last meeting of the Committee, although the levels of activity are higher throughout the forecast owing to the upward revisions to last quarter and this quarter.

The slowing of activity this fall and winter projected by the Staff is attributable in part to the expected influence of inventory investment. The shift to only a small inventory decline in the second quarter following a massive run-off in the preceding quarter contributed appreciably to measured growth, and this quarter a further swing to moderate accumulation of inventories also should boost real GNP; the data for July suggest output was greater than sales. However, the level of borrowing costs, prospects of limited price increases, and short delivery times all provide incentives to constrain inventory growth. The staff forecast allows for stocks to rise in line with sales which means that the kick from inventories wanes later this year and especially in 1984.

A much more important element than inventories in recent and prospective developments is the behavior of consumers. During the second quarter, consumer spending rose at the exceptional and unsustainable rate of nearly 10 percent in real terms. A good deal of the spending increase occurred in April and May, with retail sales excluding autos changing little in June and July. Auto sales, however, have continued to move higher even though dealer sales incentives appear to be diminishing. We expect consumer spending to continue to be supported by strong gains in employment and income in the near term, as well as by the nearly $30 billion tax cut that took effect last month. But one constraint on spending increases is by the historically low 4 percent personal saving rate last quarter. The forecast contains a little increase in that saving rate over the balance of this year, with consumer spending next year tracking gains in disposable income.

In the housing sector there is accumulating evidence of a slowdown in the making given the higher level of mortgage rates prevailing in the market. Although the ceiling rate on FHA-insured mortgages was reduced 1/2 percentage point effective today, the rate is still above that at the time of our previous forecast and conventional rates are higher as well. Housing starts in July were about unchanged from the month earlier, with single family starts down for the second consecutive month while the often lagging multi-family starts continued to rise. Qualitative reports point to an appreciable reduction recently in mortgage loan applications, an increase in contract cancellations, and builder concerns about sales that we expect to show through in lower housing starts over the balance of the year. The forecast has some growth in the housing sector next year consistent with the projected downward drift in long-term interest rates.

Business fixed investment still seems poised for further appreciable expansion and should provide some impetus to overall economic growth, especially next year. Orders for producers durable equipment look good on average and we foresee a continued strengthening of outlays for equipment; at the same time the worst of the drag from the energy sector seems to be about behind us while the declines in the nonresidential building area are expected to have run their course soon.

For both the government and net export areas there is little new to report and we have not made significant changes to the forecast.

On the price side of the forecast we have added a few tenths to projected inflation rates for both this year and next. There were two main factors behind the upward revision, one being the higher level of activity and thus reduced slack in the forecast and the other being the deterioration in the farm sector. We are now projecting food price increases of a little more than 7 percent next year, but it could get worse depending on the weather.

Finally, I might note that the CPI for July was released this morning. It shows an increase of 4.8 percent for all items and 6.7 percent for all items excluding food and energy .

FOMC BRIEFING
Stephen H. Axilrod

August 23, 1983

The strategic decision at this meeting about whether any further adjustment is needed on the degree of restraint on bank reserves—and if so in what direction—can be evaluated from the narrow perspective of the behavior of the monetary aggregates during the June-to-September short-term targeting period or from a broader and longer time perspective looking into the fourth quarter and beyond.

Tendencies of the aggregates thus far this quarter in relation to their short-term targets do not seem to suggest the need for any particular or significant adjustment in pressure on bank reserve positions. If the bulk of weight is to be placed on M2 and M3 in that evaluation, there is indeed some argument for a slight lessening in the degree of reserve pressure. These agregates have been running below their short-run target paths, but that may be the result of special factors (e.g., the enlarged availability of U.S. Government balances as a source of funds to banks last month) that diminished for a time the aggressiveness with which banks offered managed liabilities. M2 and M3 are expected to grow more rapidly over the weeks immediately ahead, though to date the data appear to be lagging our expectations. On the other hand, M1 growth has remained a shade above its short-run path, though the growth rate does seem to be abating further as best can be judged from early August data. Given the usual range of error around projections of the aggregates, there appears to be no compelling technical reason to adjust the three month specifications contained in the last directive, even though the blue book does show minor adjustments in relationships among the aggregates based on present trends.

I should note in this context that growth in the income velocity of M1 does at last seem to have turned positive, though remaining relatively low as compared with earlier cyclical experience in the second and apparently also in the current quarter--and is expected to remain low in the fourth quarter along with a projected moderation in GNP growth. There has been, incidentally, a more rapid and cyclically "normal" growth in the velocity of old M1A--currency and demand deposits--thus far in the expansion phase of the current business cycle. Through the first three quarters of the current expansion in economic activity, growth in M1A velocity has been only a bit lower than the average of five postwar expansions (excluding the expansion beginning in QIV 1949, still influenced by stored up liquidity from World War II, and the one beginning in QIII 1980, distorted by the introduction of NOW accounts on a nationwide basis). Velocity growth in the current cycle has been largest in the second and third quarters, when shifts out of demand deposits to MMDAs and Super NOWs were not likely to have been a distorting factor on M1 growth. It is hard to come to any firm conclusion about policy implications from those facts, but they might suggest that the present M1 does contain savings elements that drag down its velocity growth and that the relationship between pure transactions money and the economy is not radically different from earlier periods.

Any need for a change in restraint on reserve positions over the next few weeks would seem to depend at this time less on recent behavior of the aggregates and expectations over the very near-term than on an assessment of future behavior looking into the fourth quarter and beyond. We have projected, judgmentally, some little further rise of interest rates into the fourth quarter, consistent with the GNP projection, followed by a tendency for rates to decline in 1984. This rise is not inconsistent with models I've looked at--from the Board and from Reserve Bank economists--though two of the equations do suggest a larger rise of interest rates than we have projected judgmentally would be needed to restrain M1 to within the 5 to 9 per cent long-run path for the second half of this year, given the staff's GNP forecast. On the other hand, all those models from which an M2 estimate can be derived suggest little trouble in hitting M2 at around <u>current</u> interest rates.

Looking even further ahead, into the year 1984, our projections indicate a tendency for nominal interest rates to decline, not rise further--which may seem a bit surprising, given (a) the continuing growth of real GNP at a rate not very different from that evident in the second year of earlier expansions, (b) the failure of the federal budget to turn less expansive as the economic recovery continues, and (c) a presumed increase in the expected real return on capital on the part of businesses in face of the strong increase in consumer demand for their products (which should make business willing to borrow at higher real and presumably therefore high nominal rates). Nonetheless, there are several reasons for anticipating some decline in nominal interest rates next year, both short- and long-term.

First, our projection of inflation remains quite moderate and is on the low side of current forecasters; if our projection turns out, long-run inflation expectations in the market may diminish again (they may have recently risen as the economy strengthened), dragging nominal interest rates down with them. Moreover, a moderate price rise will work to keep the growth in nominal income within a range that might be comfortably financed by the Committee's money targets, and thus keep upward pressure off short-term rates.

Second, our projection does call for a marked deceleration in consumer spending next year, which may affect perceived needs for new capacity and hold down any increase in the expected real return from business investment in plant and equipment. Under the circumstances, businesses might not be prepared to borrow at higher real, and by implication, nominal rates than now.

And third, we continue to expect a large, indeed increasing, net inflow of capital from abroad to supplement domestic savings and permit expansion of real purchases by domestic sectors in excess of the nation's output--which works at least to dampen upward pressures on interest rates.

There are obvious risks that all three reasons for expecting nominal rates to decline next year may not work out. For instance, the budget could be even more expansive. And a change in the attitudes of foreign investors should not be neglected as a possibility. If foreigners should become less willing to supply their savings to us--either because economies expand more than expected abroad or because there is simply not much capital left abroad that will move for safe haven reasons--this could well place upward pressure on our interest rates. One route would be through the upward impact on our domestic price level of what could then be a very substantial depreciation of the dollar. Another route would be if a diminished U.S. current account deficit here-spurred, say, by greater economic growth abroad--was not accompanied by a concomitant increase in the propensity to save by U.S. domestic sectors to permit the domestic investment and the budget deficit consistent with projected real GNP growth to be financed at around the assumed interest rates.

These brief comments on broader influences on the longer-run outlook for interest rates together with the somewhat uncertain interpretation of and prospects for money (not to mention GNP) over the near-term all seem to suggest, not very dramatically, a cautious or "wait and see" approach to monetary policy over the near term.